

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Harman Analyst: Marion Mann DeJong Bill Number: AB 377

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 05/08/2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Water's-Edge/FTB Follow IRS Profit Split Rules for Audit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED
February 20, 2001, STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY

This bill would require a water's-edge taxpayer that has an affiliate company located in Puerto Rico to account for profits by assigning 50% of its profits to each entity (profit split method) if the taxpayer ever made a federal election to use the profit split method.

SUMMARY OF AMENDMENT

The May 8, 2001, amendments would:

- require the use of the profit split method for California purposes if the profit split method was ever elected for federal purposes,
- preclude use of the profit split method for California purposes if the profit split method was not elected for federal purposes, and
- add a statement of public purpose since the bill's provisions would result in a gift of public funds.

The May 8, 2001, amendments resolved the policy consideration raised in the department's analysis of the bill as amended April 24, 2001. The "Purpose of Bill," "Federal/State Law," "Legislative History," and "Other State Information" discussions from the analysis of the bill as introduced February 20, 2001 still apply. The May 8, 2001, amendments did not change the revenue estimate.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input checked="" type="checkbox"/> N	<input type="checkbox"/> OUA	<input type="checkbox"/> PENDING

Legislative Director

Date

Brian Putler

06/12/01

The "This Bill" and "Argument/Policy Concerns" discussions have been updated to reflect the May 8, 2001, amendments. In addition, "Implementation Considerations" has been updated to reflect a new concern regarding claims for refund. The remainder of this analysis was contained in the previous analyses (as introduced February 20, 2001, and as amended April 24, 2001) and is provided below for convenience.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would apply to all "open" taxable years.

POSITION

Neutral.

At its May 2, 2001, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on this bill as amended April 24, 2001, with Annette Porini, on behalf of Member B. Timothy Gage, abstaining.

Summary of Suggested Amendments

Amendment 1 is provided to resolve a new implementation concern. See "Implementation Considerations" below.

ANALYSIS

THIS BILL

This bill would create a conclusive presumption that if a taxpayer elects to use the profit split method for federal purposes (Internal Revenue Code Section 936), the result is the proper allocation of income to California under the transfer pricing rules (Internal Revenue Code Section 482).

This bill would specify that if a taxpayer *at any time* elected the profit split method for federal purposes, the profit split method *must* be used for state purposes. If, however, a taxpayer does not elect to use the profit split method for federal purposes, the profit split method could not be used for state purposes. Thus, this bill would essentially require a taxpayer to use the profit split method for California purposes if the profit split method was ever elected for federal purposes.

IMPLEMENTATION CONCERNS

According to the sponsor of the bill, the author intends to allow taxpayers that allocated income using transfer-pricing rules to file a claim for refund to use the profit split method. The language of the bill could be interpreted to prevent the filing of such claims. Amendment 1 would resolve this issue.

If the attached amendments are accepted, implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

FISCAL IMPACT

This bill would not significantly impact the department's costs. To the extent that this bill simplifies or reduces transfer-pricing audits and reduces disputes between taxpayers and the department, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 377 As Amended 5/8/01 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$22	-\$21	-\$26

Estimates assume the bill would be effective January 1, 2001, and would apply to all years for which the statute of limitations is open.

Tax Revenue Discussion

The tax differential between following IRC Section 482 transfer-pricing rules and IRC Section 936 profit splitting rules would determine the revenue impact of this bill. Based on an analysis of tax returns of corporations under audit for transfer pricing issues, tax differentials were approximated and projected to years when uninitiated audits for open years would likely be completed. Due to the sunset of Section 936 for income years beginning on or after 2006, the level of revenue losses would begin to decline starting in later fiscal years. Because an expired federal election would still be binding for state purposes, potential revenue losses would continue to exist, although likely to be insignificant, as long as corporations that made the federal election continue their business activities in Puerto Rico.

ARGUMENTS/POLICY CONCERNS

- This bill specifies that if the taxpayer at any time elected to use the profit split method for federal purposes, then the profit split method shall apply for California purposes. Thus, the profit split method would be required for California purposes even if the taxpayer later elects out of the profit split method for federal purposes. In addition, the profit split method would be used for California purposes even after the federal provisions expire in 2006. This concern could be resolved by amending the bill to clarify that the profit split method would apply for only those taxable years in which the taxpayer had a valid federal election in effect for the same taxable year.
- IRC Section 482 (transfer-pricing) audits are very resource intensive for the department and the taxpayer. For this reason, California is not required to conduct an IRC Section 482 audit if the IRS has conducted such an audit. With a conclusive presumption that the profit split method elected under federal law provides the correct value under IRC Section 482, this bill would reduce the number of IRC Section 482 audits the department is required to conduct.

On the other hand, the profit split method may not accurately reflect California income for those taxpayers that are using that method. Further, the profit split method was the result of a policy implemented by the federal government to encourage economic growth in Puerto Rico and other U.S. Possessions. California may not have the same policy reasons for encouraging economic growth in the U.S. Possessions.

- During the negotiations for the original water's-edge legislation, taxpayers that advocated treating possession corporations outside of the water's-edge agreed to be subject to the IRC Section 482 transfer pricing rules. It was contemplated that full transfer pricing audits, either by the federal government or by California, would have to be conducted to ensure that income was not inappropriately moved outside the water's-edge to lower California tax. This bill would rescind part of those water's-edge statutory provisions. In addition, this bill would essentially provide possession corporations double preferential treatment compared to other foreign corporations because other foreign corporations (1) are subject to IRC Section 482 transfer-pricing audits, and (2) must suffer the tax consequences of adjustments for failure to produce an arm's length price.
- Proponents of this bill argue that it would provide California taxpayers with certainty regarding their income tax liabilities, at the same time saving California certain costs of tax administration.
- This bill could ease the computation of the California tax return because it would allow taxpayers to use the profit amounts used for federal purposes for determining state income.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 377
As Amended May 8, 2001

AMENDMENT 1

On page 4, modify line 22 as follows:

of combined taxable income as if adjusted ~~under the principles of~~ Section 482 of
the Internal Revenue Code